

THE PINCHAS SAPIR CENTER FOR DEVELOPMENT
TEL AVIV UNIVERSITY

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Discussion Paper No. 10-2023

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Abstract

Class actions feature severe agency problems, resulting from the divergence of interests between class members and the class attorney. This paper proposes a novel mechanism for selecting the class attorney and aligning her interests with those of the represented class. The mechanism applies a combined percentage and hourly litigation fee structure, suggested by Polinsky and Rubinfeld (2003), in which lawyers earn a percentage of the class' common fund, and bear the same percentage over their time investment. To guarantee a maximum expected payoff for the class, we supplement this fee structure with a preliminary two stages auction, in which the role of the lawyer is tendered using competitive bidding. We prove that the proposed auction would leave the class with the highest possible net payoff. The percentage taken by the lawyer would be the lowest possible, and the winning lawyer would be the one who produces the highest expected net payoff for the class. We then extend the model to cases where the attorney files the class action is compensated for her pre-filing investment, and to settlements.

JEL: K41, K22

1. Introduction

For over fifty years, class actions in the U.S. have been initiated and litigated by self-driven entrepreneurial lawyers. Lawyers have taken the risks and costs of pursuing class action litigation, in the hope of obtaining a class-wide relief, out of which they would earn their fees. Those fees, usually calculated on a contingency percentage basis, have fueled the engines of American class actions (Miller, 2018; Coffee, 2015).

However, the entrepreneurial, private attorney general model, has had its inherent costs. Since lawyers' incentives are not fully aligned with class members' interests, opportunities for rent-seeking have allegedly produced agency problems that were manifested both in inadequate litigation incentives and in potentially collusive settlements (Coffee, 1987; Macey and Miller, 1991).

A solution to agency problems in the context of individual litigation was suggested by Polinsky and Rubinfeld (2003).² To align the interests of the lawyer and the client, Polinsky and Rubinfeld (PR) have proposed that the lawyer would pay a third party an upfront premium, and in return the third party would compensate the lawyer for a certain fraction of her costs. This fraction is the complement of the percentage earned by the lawyer over the litigation or settlement outcome. Thus, the percentage earned by the lawyer, and the percentage of the costs she has to bear are equalized.

The PR incentive scheme provided a solution to the lawyer's moral hazard problem. Yet, it did not address two additional challenges which are critical for maximization of the client's expected payoff: how to select the optimal lawyer, and how to minimize her fee. In the context of class actions, these challenges become critical, as lawyers often initiate the litigation and there is no market to choose among them and facilitate their fee.

This paper resolves both challenges, by supplementing the PR scheme with a preliminary auction. The auction mechanism selects the best lawyer for the class and pays her the minimum fee required to motivate her to litigate the class action.

The proposed auction is divided into two stages. In the first stage, risk neutral insurers bid the highest percentage they are willing to pay the representing lawyer, over the hours she invests in the case. In the second stage, lawyers bid the highest price they are willing to pay to represent the class, given the percentage set in the first stage auction. The winning lawyer's bid is paid to the winning insurer, and she is compensated according to the PR scheme, where her percentage is the complement of the percentage bid by the winning insurer.

As we prove, these auctions would leave the class with the highest possible net payoff. The percentage taken by the lawyer would be the lowest possible, and the winning lawyer would be the one who produces the highest expected net payoff for the class. The intuition for this result is the following: If the entire proceeds from the lawsuit were auctioned to the lawyer who was willing to pay most, then the winner would be the lawyer whose net expected payoff from the lawsuit was maximal. She would be the one who can produce the highest net litigation payoff. Under competitive bidding, her bid would equal the net value of the sole ownership of the litigation.

Now suppose that instead of auctioning the whole claim, we auction only some percentage of it. Since the PR fee structure guarantees that the total value of the claim would not be affected by the lawyer's percentage, the price offered for this percentage would equal the winning bid in the sole ownership auction, multiplied by that percentage. This implies that the same lawyer would win both auctions.

The lawyer's profit over this lawsuit would equal her percentage, multiplied by the lawsuit's net expected value (value minus costs), minus the upfront premium to the insurer. Since insurers bid the highest percentage they are willing to pay, the winning bid would be such that the expected payment to the lawyer would equal the premium she pays upfront. Thus, the lawyer would bear her full litigation costs (the insurance premium plus her share of the litigation costs), which would equal her expected fee, leaving the class with a maximal net payoff.

The proposed auction should be compared to two alternative auction mechanisms that have been suggested or practiced in the past. One proposal was to auction the *total claims* of all class members (Macey and Miller, 1991; Macey and Miller, 1993). According to this proposal, the winner would pay his bid and distribute it among class members, and then prosecute the class action against the defendant, in his name. Since the winning bidder becomes the owner of the claim, he would act as his own agent. As the sole owner of the claim, he would conduct the litigation and settlement just like any other litigant (including the defendant), thus unraveling the problem of misalignment between the class and its representatives.

Although this proposal was theoretically appealing, courts have never implemented it. First, and foremost, such an auction would violate the prohibition on claim selling.³ Second, it would require potential buyers to dedicate sufficient funds to compensate all class members, before the class action is certified, and hence before class members are defined and identified (Harel and Stein, 2004). Finally, since the winner in the auction pays for the *expected* value of the class action, evaluated before discovery and litigation, that value would be the same irrespective of the actual liability of the defendant. As we

show, our proposal realizes the same optimality outcomes as the full claim auction, without being subject to these problems.

An alternative auction mechanism for the class attorney position has been experimented with by courts.⁴ In these auctions, lawyers were required to submit their requested percentage fee, which they could condition on the stage the litigation concludes. These auctions have been harshly criticized.⁵ Most significantly, the concern was that this type of auction creates a ‘race to the bottom’, driving both the quality of the winning bidder and his incentives to litigate the case properly, away from what the class would have required (Bebchuk, 2002; Fisch, 2002). Competitive bidding over the attorney percentage puts insufficient weight on qualitative dimensions of the choice of counsel, and it results in a too low percentage, which falls below the optimal level from the class’ perspective. Thus, this type of auction not only fails to resolve the class attorney agency problem, but it might even aggravate it. As we prove, these problems are resolved by our proposed auction mechanism, combined with the PR fee structure.

As we show, the proposed mechanism can be accommodated into alternative financing and litigation regimes. It may be employed in securities class action litigation in the U.S., which vests the lead plaintiff, who holds the largest financial interest in the relief sought, with the authority to select and retain class counsel.⁶ Furthermore, we show how the optimal scheme may be combined with an independent payment to the filing attorney, and at the same time allow him to participate in the auction. Thus, the proposed scheme would not undermine the incentives of lawyers and class members to initiate claims and file class actions.

Additionally, we demonstrate how the auction mechanism may be used by courts not at the filing stage, but only after settlement. As we show, allowing objectors to class

action settlements to bid for replacing the class attorney and represent the class, facilitates an unbiased estimate of the expected value of the case, which may then be compared to the proposed settlement. If the settlement value for the class is lower, it should not be approved.

Section 2 presents the formal model, and derives the main results. Section 3 extends the model to cases where the class representative or attorney holds some independent share of the litigation outcome, and to settlements. Section 4 concludes. Proofs of the Propositions are relegated to the Appendix.

2. The Model

We present a simple model in which a class representative files a lawsuit against a defendant. The class representative must choose one out of n different attorneys to handle the case. For each class attorney $i \in \{1, \dots, n\}$ the hourly fee is w_i , which equals her marginal hourly cost.⁷ After the case is filed the class representative chooses the number of hours to spend on litigation, which is denoted by $h_i \geq 0$. For each attorney i , and litigation investments h_i the class prevails with a probability $p_i(h_i)$ that is increasing and concave in h_i and that is such that $p_i(0) = 0$. The award for the class if it wins the case is a .⁸ The lawyers' reservation payoff is assumed to be equal to zero.

We initially identify the first best outcome for the class, assuming the class representative observes all the parameters for every lawyer i . We then show how this outcome can be realized if the lawyer is chosen by the court, which may verify w_i and h_i but does not know $p_i(h_i)$.

a) An Optimal Outcome for the Class

We begin by examining the optimal outcome for the class, assuming no agency problems impact the class representative.

For each attorney i the expected litigation payoff to the class, denoted V_i , is given by

$$V_i = p_i(h_i)a - w_i h_i. \quad (1)$$

Maximizing this payoff we obtain the first order condition, solved by h_i^* :

$$p_i'(h_i^*) = \frac{w_i h_i^*}{a}. \quad (2)$$

Hence, the class' maximal expected payoff if represented by lawyer i is:

$$V_i^* = p_i(h_i^*)a - w_i h_i^*. \quad (3)$$

The class representative would therefore choose the lawyer i^* who maximizes this expected payoff:

$$V^* = \max_i V_i^* \quad (4)$$

and would cover her litigation expenses $w_{i^*} h_{i^*}$.

b) An Optimal Incentive Scheme for Lawyers

Suppose now that the lawyer is chosen by the court, which cannot observe the lawyer's ability. Thus, the court may verify w_i and h_i but does not know $p_i(h_i)$. If the lawyer is awarded a percentage $\theta < 1$ of the outcome, according to the ordinary contingent fee, and she controls the litigation, then her investment would be lower than optimal. The lawyer's expected payoff, denoted U_i , would be

$$U_i = \theta p_i(h_i)a - w_i h_i, \quad (5)$$

and her first order condition for maximizing this payoff, solved by h_i^θ , would be

$$p_i'(h_i^\theta) = \frac{w_i h_i^\theta}{\theta a}. \quad (6)$$

Since $\theta < 1$ and $p_i(h_i)$ is concave, this implies that, from the class' perspective, the lawyer's investment would be lower than optimal, $h_i^\theta < h_i^*$.

We now show how an incentive scheme similar to the one suggested by Rubinfeld and Polinsky eliminates the conflict of interest between the lawyer and the represented class. It is a two-tiered incentive scheme in which the case is controlled by a lawyer, who earns a percentage $\theta < 1$ of the litigation or settlement outcome. In addition, the lawyer makes an upfront non-refundable fixed payment, f , to a risk neutral litigation insurer, before the litigation. In return, the insurer agrees to pay the lawyer $(1 - \theta)w_i$ for each hour she spends on the case. The lawyer has full discretion to decide how many hours to invest.

Under the proposed scheme the lawyer's payoff is:

$$U_i = \theta p_i(h_i)a - \theta w_i h_i - f = \theta V_i - f. \quad (7)$$

The first order condition for maximization is the same as (2). Therefore, the lawyer's investment, h_i^θ , which maximizes her expected payoff, equals the class' optimal choice, h_i^* , and it is independent of her percentage θ .

This leads to the following result:

Proposition 1 (Polinsky and Rubinfeld, 2003): *If the lawyer is paid a percentage θ of the award, and she is paid by the insurer $(1-\theta)w_i$ for each hour she invests in the case, then her litigation decisions are optimal for the class, irrespective of θ .*

The expected payoff to the class under this scheme is

$$(1 - \theta)p_i(h_i^*)a = (1 - \theta)(V_i^* + w_i h_i^*). \quad (8)$$

Notice, however, that in order to be able to implement this incentive scheme the litigation insurer must be able to figure out the value of h_i^* , in order to determine the correct value for the lawyer's upfront payment f that ensures that the litigation insurer can break even, or such that $f \geq (1 - \theta)w_i h_i^*$.

Moreover, the fact that the lawyer's payoff under this scheme, $\theta V_i^* - f$, needs to be nonnegative in order to induce the lawyer to agree to represent the class introduces a lower bound on the value of θ . Specifically, it is required that:

$$\theta \geq \frac{f}{V_i^*} \geq \frac{(1-\theta)w_i h_i^*}{V_i^*} \quad (9)$$

or that

$$\theta \geq \frac{w_i h_i^*}{V_i^* + w_i h_i^*} = \frac{w_i h_i^*}{p_i(h_i^*)a}. \quad (10)$$

Denote the value of θ that attains the lower bound by θ_i^* . When this value of θ is used, the expected payoff to the class is equal to

$$\left(1 - \frac{w_i h_i^*}{V_i^* + w_i h_i^*}\right) p_i(h_i^*)a = p_i(h_i^*)a - w_i h_i^* = V_i^*, \quad (11)$$

which is equal to the expected payoff to the class under the first best outcome.

c) Selecting the Optimal Lawyer by an Auction and Minimizing Her Rent

The incentive scheme proposed in the previous subsection aligns the interests of the lawyer and the class. Yet, in order to maximize the class' expected payoff the court must choose the lawyer who would maximize the class' net expected payoff, and award her the minimal percentage $\theta_i^* = \frac{w_i h_i^*}{V_i^* + w_i h_i^*}$. For each lawyer i , the court observes w_i and the number of hours invested by the lawyer, h_i but does not know the function $p_i(\cdot)$. Hence, the court can neither select the optimal lawyer, nor can it determine the value of h_i^* , or minimize the lawyer's fee $\theta V_i^* - f \geq 0$. The following auction scheme achieves an approximately optimal solution to these objectives.

We embed the auction within a Bayesian game as follows: The type of lawyer i is given by the pair: $\langle p_i(\cdot), w_i \rangle$. The prior distribution of $\langle p_i(\cdot), w_i \rangle$ induces a prior distribution of the values V_i^* . To facilitate our analysis, we assume that the V_i^* 's are independently and identically distributed on the intervals $[0, \bar{V}]$. The cumulative distribution function of each V_i^* is given by a differentiable function F .

Suppose that the court runs the following two auctions sequentially: First, it runs an auction among different possible risk neutral litigation insurers to determine the value of θ , and then it runs an auction among lawyers to determine the identity of the lawyer who would be chosen to represent the class, and the terms of her employment. The two auctions can also be run simultaneously, but not in the reverse order.⁹

Specifically, in the first auction, litigation insurers compete for the right to insure the case by bidding their proposed value of θ , with the lowest bidder winning the right to insure the case under the following terms. The winner is paid an amount θb_i by the lawyer who would win the second auction, where b_i is the winning bid in the second

auction to be subsequently determined. In return, the insurer reimburses the lawyer who wins the second auction and is chosen to represent the class an amount $(1 - \theta)w_i$ per hour.

Denote the expected value of the winning bid in the second auction by $E[b^*]$ and the expected value of the product $w_i h_i$ of the winning bidder by $E[w_i^* h_i^*]$ (below, we explain the reason that the winning bidder would work h_i^* hours). The expected rent to the winning litigation insurer is therefore given by $\theta E[b^*] - (1 - \theta)E[w_i^* h_i^*]$. The fact that this expected rent is increasing in θ implies that competition among litigation insurers would drive the value of the winning bid, denoted θ^* , down so that the expected rent to litigation insurers is equal to zero, or such that:

$$\theta^* E[b^*] - (1 - \theta^*) E[w_i^* h_i^*] = 0. \quad (12)$$

After the first auction ends and the value of θ^* becomes known, the court runs a second auction. In this second auction the different lawyers bid for the right to represent the class. Lawyers each submit a bid $b_i \geq 0$. The highest bidder wins the right to represent the class under the following terms: the lawyer pays $\theta^* b_i$ to the chosen litigation insurer. The lawyer would be paid $\theta^* a$ upon winning the case, and would be reimbursed at the rate $(1 - \theta^*)w_i$ per hour for number of hours she works, h_i .

The expected payoff of the lawyer who wins the auction and works h_i hours is therefore given by

$$p_i(h_i)\theta^* a - w_i h_i + (1 - \theta^*)w_i h_i - \theta^* b_i = \theta^*(p_i(h_i)a - w_i h_i - b_i) \quad (13)$$

Notice that this expression is proportional to the first best payoff to the class, up to a constant, so the winning lawyer would work h_i^* hours, regardless of the value of θ^* . It follows that the winning lawyer's expected payoff from winning the auction is

$$\theta^*(p_i(h_i^*)a - w_i h_i^* - b_i) = \theta^*(V_i^* - b_i). \quad (14)$$

That is, the lawyer who wins the auction pays its bid b_i , and gains the expected benefit V_i^* , both multiplied by θ^* . Lawyers who do not win the auction obtain a payoff of zero. If θ^* is equal to one, then the auction is a first price auction. If $\theta^* < 1$ then the auction is not strictly speaking a first price auction, but it can nevertheless be analyzed in the same way.

Recall that the V_i^* 's are continuous random variables that are independently and identically distributed on the interval $[0, \bar{V}]$. The following Proposition characterizes equilibrium behavior in the lawyers' auction.

Proposition 2:

(a) *The lawyer with the highest value of V_i^* wins the auction with a bid that is*

$$\text{equal to } b_i(V_i^*) = E[\max_{j \neq i} V_j^* \mid \max_{j \neq i} V_j^* \leq V_i^*].$$

(b) *The class' expected payoff approaches V_i^* as the number of lawyers increases.*

That is, in the unique equilibrium of the second auction, each lawyer would bid the expected value of the highest valuation of the other lawyers conditional on this value being smaller than the lawyer's own value V_i^* , or

$$b_i(V_i^*) = E[\max_{j \neq i} V_j^* \mid \max_{j \neq i} V_j^* \leq V_i^*]. \quad (15)$$

If lawyers bid their valuations V_i^* , and the percentage θ^* was equal to the winning bidder's θ_i^* , then the auction would have generated an expected payoff to the class that is equal to the expected payoff that is generated by the best lawyer under the first best outcome. However, the fact that lawyers bid $b_i(V_i^*)$ which is smaller than V_i^* and therefore the litigation insurers set θ^* at a higher value of the winning bidder's θ_i^* in order to break even implies that the expected payoff to the class is lower.

The winning lawyer under this scheme earns a positive rent through two channels: (1) because $b_i(V_i^*) < V_i^*$ lawyers' bids are lower than what representation is worth for them, and (2) as a result of the first observation, the value of θ^* is set larger than the value θ_i^* that is required to induce the winning lawyer to participate in the auction.

Importantly, however, the litigation insurer need not know the value of h_i^* in order for this scheme to be successfully implemented as required by the scheme described in the previous subsection, in which there was no competition among lawyers. It is only required that litigation insurers have unbiased beliefs over the realization of the winning bidder's h_i^* .

Finally, as implied by Proposition 2, as the number of lawyers who participate in the auction increases, the intensified competition among them implies that $b_i(V_i^*)$ converges to V_i^* , and the variance associated with the winning bid decreases, so that θ^* converges to the winning bidder's θ_i^* . Thus, the expected payoff to the class converges to the first best payoff under the best lawyer.

3. Extensions

a) Compensating the Filing Lawyer for Her Investment

The proposed mechanism might seem to undermine the incentives of lawyers to file class actions. There are two types of fixed costs that were left out in the model, which

might raise such a concern. First, the lawyer might need to invest some fixed costs for conducting the litigation, which are not included in her variable hourly fee. It is easily verified that if the lawyer is paid the same percentage over these costs, nothing in our analysis changes. Hence, these costs would not affect the lawyer's participation constraint and her incentives to file and litigate.

Second, if a lawyer who files a class action is not compensated for her pre-filing investment when she does not win the auction for representation, then she would be unlikely to make such an investment. This, indeed, is a valid concern, which is common to all post-filing selection procedures, including the one implemented in securities litigation according to the Private Securities Litigation Reform Act.¹⁰ In every one of them, the desirability of optimal representation stands in potential conflict with the optimal incentives to file.

This problem may be addressed by awarding the filing attorney a percentage of the case's outcome, irrespective of whether she wins the auction to represent the class or not. In fact, if the proposed mechanism is accommodated to compensate for the filing investment, it would provide better filing incentives compared to the current contingency fee regime.

At the same time, since the winning bid provides a lower bound on the expected value of the case, as the lawyers' bids shade down that value. The potential value of the auction in evaluating the true merits of the case may also assist the court in discouraging frivolous filing. If such filings produce negligible bids, the court may decide to dismiss the case. Notice, though, that the potential for such a dismissal would affect lawyer's bids in the auction and we do not analyze it here.

As we now show, allowing a lawyer who holds an independent share in the litigation outcome to participate in the auction, does not affect its outcome, and the optimality result is preserved.

Suppose a lawyer i holds a share μ_i of the class net reward. Then, his total share of the litigation gross payoff is $\theta + \mu_i(1 - \theta)$. In this case, if lawyer i is required to pay $\theta + \mu_i(1 - \theta)$ times his bid conditional on winning the auction, and the per hour reimbursement to lawyer i is set at $(1 - \theta - \mu_i(1 - \theta))w_i$, then lawyer i would exert an effort that is equal to the first best effort h_i^* . This would change this lawyer's expected bid in the auction and so also the expected payoff to litigation insurers from a bid of θ . However, competition among litigation insurers should still drive their bids for θ so that their expected payoff is equal to zero.

Lawyer i 's payoff from representing the class, under this proposed incentive scheme, would be $(\theta + \mu_i(1 - \theta))p_i(h_i)a - \theta w_i h_i - f$. His payoff if another lawyer, j , represents the class would be $(\mu_i(1 - \theta))p_j(h_j)a$. As we prove, bidding an amount that is equal to the expected value of the second highest valuation conditional on winning is still an equilibrium of the first price auction.

Proposition 3:

The bid functions $b_i(V_i) = E[\max_{j \neq i} V_j \mid \max_{j \neq i} V_j \leq V_i]$ form an equilibrium of the first price auction. In this equilibrium, the lawyer with the highest value of V_i^ wins the auction, pays $(\theta + \mu_i(1 - \theta))$ times his bid, and his per hour reimbursement is set at $(1 - \theta)(1 - \mu_i)w_i$.*

Intuitively, the bidding function which maximizes a lawyer's payoff in the auction under the equilibrium suggested in Proposition 2, would also maximize her payoff if

she holds a percentage of the class payoff, given that all other lawyer maintain their bidding strategies. Making a higher bid would result in that lawyer representing the class even where another lawyer would better represent it. Since this strategy was dominated by the optimal bidding function when the lawyer had no percentage of the class payoff, it would prove even worse now, as she would also lose from not being optimally represented. Making a lower bid would be dominated by the previously optimal bid function, for similar reasons.

b) Settlement

Our model has abstracted from the possibility of settlement. The information the defendant has over the lawyer's quality, and the bargaining mechanism between the parties, may have implications over the initial auctions, which go beyond the scope of this paper.¹¹ Yet, as we show next, in the context of class actions, the proposed auction mechanism may be used not only for the initial selection of the lawyer, but also for allowing the court to review proposed settlements.

Unlike in ordinary litigation, class action settlements must be approved by the court. The court may approve the settlement only if it finds that it is fair, reasonable and adequate.¹² The court's problem at this stage, however, is that the representing plaintiff and her lawyer, as well as the defendant, all support the settlement. Class members may file objections to the settlement,¹³ but courts often find it difficult to estimate the case's litigation value, which is necessary to decide whether the settlement satisfies the requirements for approval.¹⁴

The proposed two-stage auction mechanism may help the court to make this exact estimation. If objectors are required to participate in a similar auction, in which they

bid for representing the class if the settlement is not approved, the court may learn the minimum value for which the case should settle, as the auction reveals its litigation value.

We next show that using the auction mechanism after a settlement is proposed is equivalent to conducting the auction with the settlement as a minimum price.¹⁵ As we prove, our results are preserved under this modified auction. In particular, the winning bid would approximate the expected net value of the case. The court should then approve the settlement only if no bid is submitted which is higher than the proposed settlement. Otherwise, it should reject the settlement and proceed with litigation, which is to be conducted by the winning lawyer-objector.

Proposition 4:

Suppose that the proposed settlement is S . Then, the lawyer with the highest value of V_i^ wins the auction with a bid that is equal to $b_i(V_i^*, S) = E[\max_{j \neq i}\{V_j^*, S\} \mid \max_{j \neq i}\{V_j^*, S\} \leq V_i^*]$ provided that $V_i^* \geq S$. If all the values V_i^* are smaller than S then lawyers decline to participate in the auction, and the settlement is approved.*

It should be noted that in the presence of a reserve price S , lawyers are driven to either bid higher than they would without a reserve, or drop from the auction. This implies that the settlement S necessarily increases the expected payoff to the class compared to the case without a settlement.

4. Conclusion

This paper shows how auctioning the role of class attorney, structured in the particular manner suggested, can realize optimal outcomes for represented class members, and overcome agency problems and conflicts of interests. It allows courts to facilitate competition among lawyers and guarantee maximum payoff to class members. Moreover, since the proposed auction gives courts a strong indication about the value of the case, they may use it to verify the adequacy of class action settlements.

The proposed mechanism can be accommodated into alternative financing and litigation regimes. It may be employed in securities class action litigation in the U.S., which vests the lead plaintiff, who holds the largest financial interest in the relief sought, with the authority to select and retain class counsel. It can also be implemented in other class action regimes, most significantly in Australia, which depend on litigation funders to facilitate class action litigation.¹⁶ As long as the controlling agent, be it the attorney, the lead plaintiff, or the funder, is selected using the auction procedure, and compensated according to the proposed fee structure, optimal outcomes for the class would follow.

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¹ Buchman Faculty of Law, Tel-Aviv University, Berglas School of Economics, Tel-Aviv University, and Harry Radzyner School of Law, Interdisciplinary Center, Herzliya. For their helpful comments we thank participants in workshops at Georgetown, George Washington, George Mason, USC and Tel-Aviv Universities, as well as the Israeli, the European and the American Law and Economics Associations' annual meetings in 2019. Neeman gratefully acknowledges financial support from the Pinhas Sapir Center for Economic Development.

² A long and list of papers cited Polinsky and Rubinfeld's (2003) paper. For example see: Klement and Neeman (2004); Huang (2004); Kirstein and Rickman (2004); Davis and Cramer (2009-2010); Fuare (2012); Burch (2012); Huang (2012). See also Cooter and Porat (2002).

³ For a critical discussion of claim auctions see Moeller (2000). Thomas and Hansen (1993) are criticizing Miller and Macey (1991) proposal as unworkable in practice, and questionable under the current rules of professional responsibility; *See also* Third Circuit Task Force Report on Selection of Class Counsel, 74 TEMP. L. REV 689 (2001) [hereinafter Task Force Report] holding that the proposal is unworkable in practice, since it would violate rules of professional conduct prohibiting lawyers from having a financial interest and would require changes in the law that have not yet garnered support outside of some academic circles. The report and witness statements by numerous academics, lawyers and judges, can be found on

<https://www.ca3.uscourts.gov/sites/ca3/files/final%20report%20of%20third%20circuit%20task%20force.pdf>

⁴ See, e.g., *In re Oracle Sec. Litig.*, 136 F.R.D. 639, 641 (N.D. Cal. 1991) (first lead counsel auction). Since then, courts continued to employ the device in various securities class actions. For a comprehensive descriptive review of these cases. See Hooper and Leary (2001) and the Third Circuit Task Force Report, *supra* note.

⁵ One of the Task Force Report's main conclusions was that the traditional methods of selecting class counsel are preferable to auctions in most class action cases. See Task Force Report, *supra* note 7 at p. 18. The reason appears to be that the PSLRA, which assigns the lead plaintiff the power to "select and retain counsel to represent the class" subject only to judicial approval, prohibits the use of auctions for this purpose. In fact, it appears that following the third circuit report this the auction process screeched to a halt in 2002, Task Force Report, *supra* note at p.61.

⁶ For further reading on the lead plaintiff provision under the PSLRA see: Simmons and Ryan, 2003; Perino, 2006; Nelson and Pritchard, 2007; Choi, Fisch and Pritchard, 2007; Cox, Thomas and Bai, 2008; Choi, 2011; Choi and Pritchard, 2018.

⁷ As pointed out by Wickelgren, 2004, a divergence between that lawyer's hourly fee and her hourly cost could result in either higher or lower investment in the case. However, as Wickelgren shows, if the lawyer's hourly fee is set in advance so that it would be higher than his hourly cost, then the only problem would be that the lawyer might have an incentive to invest too much in the litigation. In our proposed mechanism, this might increase her auction bid, and consequently result in a lower percentage in the insurers' bids.

⁸ Although we focus on litigation outcomes to simplify the main part of the analysis, the model can be extended to incorporate settlement negotiations, as we did in a

previous draft available on SSRN: <https://ssrn.com/abstract=3329380> or

<http://dx.doi.org/10.2139/ssrn.3329380>. See also Polinsky and Rubinfeld (2003).

⁹ This is because knowledge of the winning lawyer's bid b_i would affect the value of the winning θ , which would feed back into the determination of b_i .

¹⁰ Private Securities Litigation Reform Act of 1995, 15 U.S.C.A§ 78u-4. The lead plaintiff provision under the Private Securities Litigation Reform Act (PSLRA) addresses the appointment and the required qualifications of the lead plaintiff in securities class actions. The provision established a rebuttable presumption that the most adequate class member seeking appointment to represent the class is the one who has the largest financial interest in the relief sought by the class. The provision vests the lead plaintiff with authority to select and retain class counsel. According to section (a)(3)(B) the court shall consider any motion made by a class member and appoint as lead plaintiff the member of the purported class that is most capable of adequately representing the interests of the class. According to section (a)(3)(B)(v) the court vests the lead plaintiff with the authority to select and retain class counsel.

¹¹ Polinsky and Rubinfeld 2003 show that their fee structure provides optimal settlement incentives to the lawyer. Yet, they do so in a specific information and bargaining structure, where defendants hold private information about their costs, and plaintiffs have full bargaining power (making a take-it-or-leave-it offer). Wickelgren 2004 discusses settlement only informally.

¹² Federal Rules of Civil Procedure Rule 23(e).

¹³ Federal Rules of Civil Procedure Rule 23(e)(5).

¹⁴ Hay and Rosenberg (2000); Coffee (1995); Koniak (1995); Koniak (1996).

¹⁵ For a different proposal to auction the whole class action to settlement objectors see Tidmarsh (2014).

¹⁶ See: Barker (2012); Kalajdzic et al (2013); Morabito (2017); Waye & Morabito (2018); Grave et al (2012); Clark (2007); Morabito (2012). For the involvement of litigation funders in class action litigation in the U.S. see: Avraham & Sebok (2019); Hensler (2014); Burch (2012); Issacharoff (2014).